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FASB Principles-based standards proposal Comments by Kell B. Rabern, CPA

My opinion is that principles-based standards is the best option at this point. What I see as necessary is a set of Core Principles, written to serve as a filter through which all financial presentations must pass. If those Core Principles are established, then all of the more specific standards should include the following statement:

"The provisions of this statement are required to be applied in the context of compliance with the Core Principles. Therefore, to the extent this statement allows discretion, that discretion should be applied to achieve the greatest level of compliance with the Core Principles."

The reason this shift to a principles-based approach is necessary is that cultural shifts have made accounting more a system for inventive loopholes than a system of ensuring fair reporting. I have outlined my observations about some key elements of the cultural / behavioral trends in the attached Summary A, with comments about how the Principles-Based approach should be advantageous over the Rules-Based approach. The decision needs to be made based on which approach is most likely to be advantageous over the other, considering the behavioral trends. Summary A may be criticized as representing a cynical view. However, it is intended only to focus on some negative trends, which may be counteracted with a renewed focus on principles. There are not bad accounting standards or bad principles, but only bad motives as the standards are applied. Therefore, the solutions do need to fairly consider the core motives for misapplications.

With that introduction, I would now like to focus on just what are the Core Principles, through which any financial presentation should be tested and evaluated. I have drafted my suggestion for the Core Principles, attached as the Core Principles document.

There is nothing new in the Core Principles. These have been in our professional expectations all along. However, it is important to bring them to the forefront as a concise body of authority, and referencing them in each of the more specific standards. Thereafter, each of the more specific standards may be written to more directly and simply declare the accounting objective it addresses, with minimal detailed rules.

For example, FASB 13 and all of its related statements and interpretations could be expressed as: "The objective of standards for accounting for leases is that lease transactions and financing transactions that are the same, or nearly so, in substance should be accounted for the same."

#### In summary:

 Yes, I support the Board's proposal for a principles-based approach to U.S. standard setting. Yes, that approach will improve the quality and transparency of U.S. financial accounting and reporting.

Reasons: It is more likely to refocus the accounting profession on core principles and it is more likely to counteract some disturbing cultural / behavioral trends.

- 2. No opinion at this time re IAS 1 and "true and fair view override".
- Interpretive and implementation guidance should be provided within six months after each FASB statement. Yes, the Board should be the primary standard setter responsible for providing that guidance.

Reasons: The Board will have accumulated a thorough understanding of the views of respondents during its "due process". The Board therefore will best be in position to translate the standard into interpretive and implementation guidance.

 Yes, I believe the preparers, auditors, SEC, investors, creditors and other users will be able to adjust to a principles-based approach to U.S. standard stetting.

Reasons: The major adjustment needed is "coming to grips" with a risk that comparability will decrease. I believe that the Core Principle addressing Comparability will work to minimize that risk. Once all the parties understand the dynamics of how comparability is achieved, adjustments should go fairly smoothly.

As for what needs to be done, and by whom, I see a need for a change in the legal system. The legal presumption that "anything is legal as long as it cannot be proven to be technically illegal or incorrect" needs to change in the area of financial reporting. This issue seems to border on the pervasive presumption of innocence until proven guilty. In financial presentations for which the public interest must be protected, the legal presumption should be that a financial presentation is not misleading as long as it achieves compliance with the Core Principles. An ancillary presumption is that departure from the spirit of the Core Principles is not justified. I do not know if this change in presumptions is something that can be engineered, whether by state laws or otherwise.

### 5. Benefits and costs.

Benefits: a) Less exposure of investors, creditors and employees/retirees to losses due to reliance on misleading financial presentations.

b) Accounting profession, and reporting entities, better able to attract and retain personnel who find their value in delivering reliable financial presentations and who are repulsed by presentations that are patently deceitful or creatively inventive with intent to mislead.

Costs: a) Litigation costs may increase as cases involve more focus on

judgment about principles and less ability to make decisions based on specific rules.

I have no suggestions on quantifying benefits and costs.

#### 6. Other factors to consider:

- A) Reducing the undesirable appearance of the accounting profession: The complaints of "standards overload" throughout the history of the FASB have been significant at keeping or driving people away from the accounting profession. For the accounting profession to be vibrantly staffed with bright and creative people, both in reporting entities and CPA firms, simplification is a critical need. Simplification will enhance the ability of the profession to attract and retain people who can believe in the enjoyment and rewards of their profession. It is not presently viewed as enjoyable or rewarding, for the most part. Simplification will work to restore enjoyment, as accountants can derive value from greater exercise of judgment and lesser burden with highly complex and detailed rules.
- B) Reducing the desirability of complex business structures that may have purpose primarily to obfuscate and mislead. If entities come to understand that they cannot succeed in using complex business designs to avoid the level of reporting transparency that will be expected of them, the creation of such designs should be decrease. With that, there should come a decrease in creation of non-U.S. entities that circumvent and undermine the U.S. tax systems and other laws.

Respectfully submitted,

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#### Attachment 1

FASB Principles-based standards proposal Core Principles

#### No. 1: Relevance

Financial presentations should be relevant, meaning capable of making a difference in a decision by helping users to from predictions about the outcomes of past, present and future events or to confirm or correct prior expectations. Timeliness, that is having information available to decision makers before it loses its capacity to make a difference, is an ancillary aspect of relevance. Those who prepare financial presentations have a core responsibility to ensure that it includes the relevant information.

#### No. 2: Reliability

Financial presentations should be reliable, meaning information must be representationally faithful, verifiable, and neutral, in reporting economic activity as faithfully as possible. That is, it must not be intentionally biased to attain a predetermined result; for example, to foster a particular government policy, to favor one economic interest over another, or to otherwise influence behavior in any particular direction. To do so would undermine the proper functioning of the capital markets, limiting the ability of investors and creditors to make informed capital allocation decisions. The principle of reliability requires financial presentations to neutralize the reporting entity's interest relative to the public interest of users of the information, by requiring honest and fair reporting.

## No. 3: Comparability

Financial presentations should be comparable, meaning the presentations of similar transactions and events are accounted for similarly, and different transactions and events are accounted for differently. The objective in ensuring comparability is to enable users of the information to fairly compare the reported information with similar information and expectations. The core principle of comparability encompasses the duty of those who prepare financial presentations to ensure that the accounting treatment is consistent with the entity's historical treatment of similar transactions and events, and is consistent with promulgated accounting standards and accounting treatments common in the entity's industry. When transactions and events that are so different by their nature or design that consistency with promulgated accounting standards or common industry treatments is not applicable or is not clear, the principle of comparability should be applied to result in a presentation that illuminates the uniqueness of the transactions and events and the related accounting treatment.

## No. 4: Substance over form

Financial presentations should reflect the substance of the transactions and events being reported, and the substance should take precedence over the form. This core principle requires preparers of financial presentations to apply accounting treatments based on the substance of the transactions or events, considering form secondarily. Where form has been designed to meaningfully alter the apparent substance of the transactions or events, with an objective to give a different accounting treatment, the financial presentation

should include a fair reporting of the reasons the entity chose that form and that accounting treatment.

#### No. 5: Conservativism

Financial presentations should be conservative, meaning the more conservative presentation should be chosen over the less conservative when there are doubts, alternatives or significant estimates involved. Financial presentations are more conservative if they result in reporting of less assets, revenues, net assets and similar measures, or if they result in more illumination of facts and circumstances in disclosures.

## No. 6: Understandability

Financial presentations should be understandable, meaning a reasonable user will be able to read and understand the information and will reasonably be led by the information to the correct understanding of the transactions and events being reported. While many financial matters are complex, the financial presentations thereof should be made with the objective of the greatest understandability. Preparers of financial presentations should choose the more direct and understandable presentation over alternatives of lesser directness or understandability.

#### No. 7: The entity

Financial presentations of a reporting entity should include all of the component entities of the reporting entity, unless clearly limited to one or more entities and fairly disclosing the omission of the others. A component entity is any entity controlled by the reporting entity, with control being a matter of substance over form.

## No. 8: Assets and liabilities

Anything reported as an asset should be within the conceptual definition of an asset, and all existing obligations within the conceptual definition of a liability should be included in reported liabilities, with valuations and allocations to be determined under applicable generally accepted accounting standards.

# No. 9: Assets based on another entity's resources

Anything reported as an asset based on another specific entity's resources, and not having economic value apart from that other entity's resources, should not be reported in excess of the current economic value of that other entity's resources, without regard to contingencies that might increase that other entity's resources. This principle applies not only to investments in and amounts due from the other entity, but also to contractual rights, deposits, prepayments and any other form of asset requiring the other entity to deliver value from its resources in order for the reporting entity's asset to have value. In applying this principle, preparers of financial presentations have a duty to obtain information about, and to evaluate, the other entity's resources whenever potential failure of that other entity's resources would have a direct and material effect on the reporting entity's financial condition.

# No. 10: Obligations and contingencies that are not liabilities

Obligations and contingencies that are not liabilities within the conceptual definition, but for which it is reasonably possible the reporting entity will pay or otherwise satisfy, should be fairly disclosed whenever disclosures are presented.

# No. 11: Conflicts of interest between management and stakeholders

Any condition or contract causing management, or another entity controlled by management, to hold a divergent financial interest or incentive relative to the entity's stakeholders should be fairly disclosed whenever disclosures are presented.

# FASB Principles-based standards proposal Analysis by Kell B. Rabern, CPA

	Behavioral trends	Advantages in Principles	Risks in Principles	Solutions to the Risks
	Postmodernism (PM) - belief that there is no objective truth	Broad principles can be designed to allow no exceptions; and to foster a focus on truth, aka "representational faithfulness".	Popularity of "PM" belief structure in those who might ultimately make findings and conclusions may work to allow the exceptions anyway. If a judge sees broad discretion allowed within the principles, his or her legal finding may also be broadly tolerant.	Require the principles to be designed to allow no exceptions. There will need to be a set of core principles acting as a filter through which any financial presentation must pass muster.
2.	Myth of presumption - belief that anything is presumed to be legal as long as it cannot be shown to be technically illegal or incorrect	Broad principles allow no exceptions; this creates the presumption that any presentation that is chosen with an intent to mislead or to manipulate is unacceptable.	Proving intent to mislead or manipulate is difficult. Could bog down entities in disputes centering on one expert's opinion versus another's.	Financial presentations should be evaluated based on proximity to the heart of the principle, not based on proximity to the outer limits of rules. This may require a shift in the legal system, to make the presumption be that any departure from the spirit of the broad principles is not justified.
3.	Greed - maximization of one's own advantage	Principles-based focus will bring more transparency, reducing the opportunity for greed to have its way.	Greed is a human condition that will find new and creative ways to seek its own way.	The system of accountability and regulation is multi-faceted, within the entity and externally. An organization can, if it chooses, develop reasonable controls against the effects of greed.
4.	Denial of personal responsibility if questioned; ignorance as a defense	Broad principles are simpler, more common sense; this limits the ability to claim ignorance as a defense. Complexity of rules fosters obfuscation; simplicity of principles fosters illumination.		
5.	Cleverness is valued - inventive loopholes and advocates thereof are valued and rewarded, the more clever at pushing the limits of rules, the better	Financial presentations should be evaluated based on proximity to the heart of the principle, not based on proximity to the outer limits of rules. This works to direct the focus toward the heart of the principle.		Investor losses, retiree losses, and other losses should bring about a new emphasis on key value for preparers and auditors of financial presentations. The new value is the revitalized version of the old value - honesty as the only acceptable policy.